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Supreme Court of the United States

October Term, 1927

No. 554

ELIZABETH C. TAFT,

Petitioner,

v.

FRANK K. BOWERS, Collector of Internal Revenue for the Second District of the State of New York,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO REVIEW THE DECISION OF THE UNITED STATES CIRCUIT COURT OF APPEALS, SECOND CIRCUIT, AND BRIEF IN SUPPORT OF PETITION.

Constitutionality of Section 202 (a) (2), Revenue Act, 1921 (42 Stat. 227). The question presented by this petition is whether the provision of the above Act, which required a donee to use the cost of the property to the donor as a basis for computing profit for income-tax purposes, was unconstitutional in so far as it taxed to the donee, as income, increment in the value of a gift which accrued prior to its acquisition by the donee.

HENRY W. TAFT,
Counsel for Petitioner,
40 Wall Street,
New York, N. Y.

Lawyers Press, Inc., 165 William Street, New York City, N. Y.

Supreme Court of the United States

October Term, 1927

ELIZABETH C. TAFT,
Petitioner,

v.

FRANK K. BOWERS, Collector of Internal Revenue for the Second District of the State of New York,
Respondent.

No.

Sir:

PLEASE TAKE NOTICE that I have filed in the Supreme Court of the United States a petition for a writ of certiorari in this cause, a copy of the record and a brief, of which copies are hereto annexed and herewith served upon you. Pursuant to Subdivision (4) of Rule 35 of the Supreme Court, the said petition, record and brief will be submitted to the Court on the first motion day following the expiration of twenty days after service of this notice upon you.

Dated, New York, September 19, 1927.

HENRY W. TAFT,
Attorney for Petitioner,
40 Wall Street,
New York, N. Y.

To—

HON. WILLIAM D. MITCHELL,
Solicitor General,
Washington, D. C.

Due service of the foregoing notice and the annexed petition, record and brief are hereby acknowledged.

Sept. , 1927.

Attorney for Respondent.

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Supreme Court of the United States

October Term, 1927

ELIZABETH C. TAFT,
Petitioner,

v.

FRANK K. BOWERS, Collector of Internal Revenue for the Second District of the State of New York,
Respondent.

PETITION OF DEFENDANT IN ERROR FOR A WRIT OF CERTIORARI TO REVIEW THE DECISION OF THE CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

To the Honorable the Supreme Court of the United States:

The petition of Elizabeth C. Taft, the defendant in error below, respectfully shows:

I. That this suit was brought in the United States District Court for the Southern District of New York to recover $2,040.09, income tax, paid under protest by the petitioner to the respondent for the calendar year 1923, on the grounds that Section 202 (a) (2) of the Revenue Act of 1921 (42 Stat. 227), under which such tax was exacted, was contrary to Article 1, Sections 2 and 9 of the Constitution of the United States, and to the Fifth and the Sixteenth amendments thereof, and

also to other provisions of the same act which should prevail in its interpretation.

II. On the hearing in the District Court the motion of the defendant, Bowers, to dismiss the complaint of the plaintiff was denied, the Court holding that Section 202 (a) (2) of the said Revenue Act of 1921, in so far as it attempted to tax to the donee the increment in the value of the corpus of a gift which had accrued prior to acquisition by the donee, and was realized by the donee by conversion after the gift, was unconstitutional. A copy of the opinion of the District Court is hereto annexed.*

III. On appeal to the Circuit Court of Appeals for the Second Circuit the judgment of the District Court was reversed by a divided Court. The order reversing the judgment of the District Court was entered on the 13th day of July, 1927. Copies of the majority opinions of Judges Manton and Hand, and of the dissenting opinion of Judge Swan, of the Circuit Court, are hereto annexed.**

IV. Ninety days have not elapsed since the entry of the said order in accordance with the decision of the said Circuit Court of Appeals.

V. The petitioner respectfully moves this Court for a Writ of Certiorari to review the decision of the Circuit Court of Appeals, Second Circuit.

VI. The case of the petitioner is based on the following facts, concerning which there is no dispute. Her father gave to her, during 1921 and 1922, 150 shares of the common stock of The Nash Motors Company, which

* Page 17.
** Pages 20, 28, 31.

he had acquired as a bonus in connection with the purchase of preferred stock and for which, therefore, he could establish no definite cost. It is admitted by all concerned that the fair market value of the stock so given, on the date of the gifts, was $42,350. By reason of stock dividends paid early in 1923 the holdings of the petitioner increased to 750 shares of common stock and 450 shares of preferred stock. During 1923 she sold a portion of the said stock for $34,345.30. It is admitted by all concerned that the portion of the capital value at the time of the gift attributable to the shares so sold was $11,708.80. Obedient to the commands of Section 202 (a) (2) of the Revenue Act of 1921, which provided:

> "(a) That the basis for ascertaining the gain derived or loss sustained from a sale or other disposition of property, real, personal, or mixed, acquired after February 28, 1913, shall be the cost of such property; except that * * *
>
> (2) In the case of such property, acquired by gift after December 31, 1920, the basis shall be the same as that which it would have in the hands of the donor or the last preceding owner by whom it was not acquired by gift. If the facts necessary to determine such basis are unknown to the donee, the Commissioner shall, if possible, obtain such facts from such donor, or last preceding owner, or any other person cognizant thereof. If the Commissioner finds it impossible to obtain such facts, the basis shall be the value of such property as found by the Commissioner as of the date or approximate date at which, according to the best information the Commissioner is able to obtain, such property was acquired by such donor or last preceding owner."

the petitioner returned the full amount of the proceeds of the sale of her stock, to wit, $34,345.30, as income, and

paid the tax thereon, protesting, however, that so much of the tax so paid, to wit, $2,040.09, as was exacted on the $11,708.80, being the increase in value accrued prior to her acquisition of the stock, was unlawful, and contrary to the provisions of the Constitution of the United States. Claim for refund of the said $2,040.09 was duly filed and after six months suit was duly brought in the District Court which raised the issue of the constitutionality of the provisions of Section 202 referred to above. (R. 4-8)

VII. For the reasons set forth in the annexed brief, your petitioner believes that the decision of the Circuit Court of Appeals was erroneous and contrary to law, and that this honorable Court should require the case to be certified to it for review and determination in conformity with the Acts of Congress in such case made and provided.

WHEREFORE your petitioner respectfully prays that a Writ of Certiorari may issue out of and under the seal of this Court, directed to the United States Circuit Court of Appeals for the Second Circuit, commanding the said Court to certify and transmit to this Court, on a day to be therein designated, a full and complete transcript of the record and all proceedings of the said Circuit Court of Appeals in the said case therein, entitled "Frank K. Bowers, Etc., Plaintiff in Error, v. Elizabeth C. Taft, Defendant in Error, (No. 280)," to the end that the case may be reviewed and determined in this Court, as provided by Section 240 of the Act of Congress designated as the Judicial Code, and that the said judgment of the said Circuit Court of Appeals in this case and every part thereof may be reviewed by this honorable Court and that the judgment of the District Court be confirmed

and that such other and further relief be granted as to the Court shall seem just and equitable and in conformity with the law.

ELIZABETH C. TAFT,
Petitioner.

HENRY W. TAFT,
Counsel.

STATE OF NEW YORK }
COUNTY OF NASSAU } ss.:

ELIZABETH C. TAFT, being duly sworn, says that she is the petitioner named in the foregoing petition, and that she has read the same, and that the allegations thereof are true, as she verily believes.

ELIZABETH C. TAFT.

Subscribed and sworn to before me
this 13th day of Sept., 1927.

WALTER H. PENNY,
Notary Public,
Nassau County, N. Y.

[SEAL]

IN THE

Supreme Court of the United States

October Term, 1927

ELIZABETH C. TAFT,
Petitioner,

v.

FRANK K. BOWERS, Collector of Internal Revenue for the Second District of the State of New York,
Respondent.

BRIEF IN SUPPORT OF PETITION.

Insert

Statement.

This action was commenced by the petitioner in the United States District Court, Southern District of New York, to recover $2,040.90, income tax, paid in the year 1923, and is reported in 15 Fed. (2) 890. Judgment was entered for the petitioner on August 20, 1926. (R. 17-18.) The Circuit Court of Appeals reversed the judgment of the District Court. The opinions of the Circuit Court are not officially reported. The order reversing the judgment of the District Court was filed July 13, 1927. (R. 43-44.) In the proceeding below the petitioner claimed that the increment in the value of certain stock, to-wit, $11,708.80, which accrued prior to her ownership, was not income (R. 7), and, hence, the statute which taxed it as such was unconstitutional. (R. 8.) The petitioner relies upon Sec. 240 of the Judicial Code as authority for the jurisdiction of this Court. All of the material facts are set forth in Paragraph VI of the Petition and on pages 4-8 of the Record. The errors to be urged are specifically set forth in Points 2, 3, 4 of this brief.

IN THE

Supreme Court of the United States

October Term, 1927

ELIZABETH C. TAFT,
Petitioner,

v.

FRANK K. BOWERS, Collector of Internal Revenue for the Second District of the State of New York,
Respondent.

BRIEF IN SUPPORT OF PETITION.

Insert

1. This case involves one of the most vital and fundamental problems of Income-Tax Law and is of nation-wide interest.

By reference to Section 202 (a) (2) of the Revenue Act of 1921, quoted in the accompanying petition, it will be noted that if a gift was made after December 31, 1920, the donee, in computing gain or loss, must use as the basis the cost to the donor or to the last preceding owner by whom it was not acquired by gift.

This is a new and decided departure in income-tax legislation. So far as diligent search has revealed, no Court has ever been called upon to pass on the validity of any similar income-tax statute, State or Federal. Despite the small amount involved, the case raises a question of great and fundamental importance, to wit: Whether Congress can constitutionally declare the increment in the value of a capital asset accruing prior to

ownership by a taxpayer to be income to that taxpayer. Thus if a person comes into the possession and ownership of property by gift and later sells the property so acquired, can he be taxed upon the basis of the increase in capital value from the time when the donor acquired it, up to the time he gave it to the donee? Is that increase income to the donee under the Income Tax Amendment? The District Court held that it was not. Upon appeal to the Circuit Court of Appeals the judgment was reversed, each of the three Judges sitting writing separate opinions, one dissenting. The two prevailing opinions did not proceed on the same lines of reasoning, nor can the opinions of the District Judge and the dissenting Circuit Judge be said to be clearly consistent. Thus, by a diversity of reasoning, two Judges have decided one way and two another. With such a contrariety of opinion upon such an important point, we submit that the interest of the public requires that the power of Congress to enact the legislation referred to should be definitely settled, especially since, of approximately six millions of persons required to make income-tax returns, many will undoubtedly be affected, at one time or another, as provisions similar to those in Section 202 (a) (2) are contained in all of the Federal Income Tax Acts since 1921.

2. The Circuit Court of Appeals erred in holding that the increment of $11,708.80 which accrued prior to the ownership by the petitioner was "income" taxable to the petitioner, or, indeed, was income at all.

This Court has defined income to be

> "The gain derived from capital, from labor, or from both combined, provided it is understood to

> include profit gained through a sale or conversion of capital assets." (Eisner v. Macomber, 252 U. S. 189.)

And the Court has since repeated and approved that definition in many cases. *Merchants Loan & Trust Co.* v. *Smietanka,* 255 U. S. 509; *Goodrich* v. *Edwards,* 255 U. S. 527. It has thus become the settled criterion of what constitutes income within the meaning of the Sixteenth Amendment.

The definition does not include the value of property received by gift, for property so acquired is not gain derived *from* capital, *from* labor, or *from* both combined. Indeed, this Court has held, in *Edwards* v. *Cuba R. R. Co.,* 268 U. S. 628, that the value of physical properties and money given to the railroad company by way of subsidy by the Cuban Government is not income:

> "They are not profits or gains from the operation of the Railroad and do not constitute income within the meaning of the Sixteenth Amendment."

So, too, in *U. S.* v. *Oregon-Washington R. & Nav. Co.,* 251 Fed. 211 (C. C. A.), it was held that where a sole stockholder of a corporation released a debt in favor of the corporation, such sum was not income to the corporation, but was a capital contribution. For like reasons a gift is a capital transaction and does not constitute income to the donee. Increment accrued merely increases the value of the gift of capital. The provisions of the statute which attempt to call it income are inconsistent with Sec. 213 (b) of the Act, which provided that the value of a gift shall not be included in income.

No part of the capital value received by way of increment necessarily becomes income when realized by sale. Mere conversion of an asset into money does not

always result in income. To be sure, gain from the sale of capital assets is income. *Merchants Loan & Trust Co.* v. *Smietanka, supra; Walsh* v. *Brewster,* 255 U. S. 536. But the principle does not go so far as to hold that the increase in value which occurred prior to ownership by the person taxed should be included as such income, and for the reason that account must be taken of the taxpayer's capital investment at the beginning of this period of ownership before income in the constitutional sense can be estimated. Otherwise the gross receipts from every sale might be regarded as gross income to the seller, and this theory has long since been discarded by the courts. *Southern Pacific Co.* v. *Lowe,* 247 U. S. 330. To state our position in another way, a donee can have profit *from* capital only when *his* capital at the beginning of his ownership is considered, just as he can have profit *from* labor only when the profit arises from *his* labor.

Analogous cases have been decided. In *Doyle* v. *Mitchell Bros. Co.,* 247 U. S. 179, the Court said:

> "In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration."

It was held that where an increase in capital value occurred before the passage of the taxing Act, such increase was not taxable as income upon the sale of the property after the Act was effective. Again, in *Lynch* v. *Turrish,* 247 U. S. 221, it was held that capital which had accrued prior to March 1, 1913, was not income, although it was later converted into cash and paid to the taxpayer after that date. No sound distinction can be drawn between

a case where the increase accrued prior to the passage of the Act and a case where it accrued after that time but prior to ownership by the present taxpayer. In the first case the increase is not taxable because it had become capital when the law took effect. In the second case it was equally beyond the power of Congress to use (in the words of Judge Manton) as "a measure of gain or loss the cost to the donor without reference to its actual value when received by the donee" because any basis of measurement must have some relation to the thing measured. It can not create that basis by regarding as income what is, in fact, capital.

Here we note an obvious error of Judge Manton, in the following statement in his decision:

> "The stock which was sold in 1923 brought $11,708 more than it was worth when she received it. In making her income-tax return and paying the same for 1923, she included the entire gain from the sale of the stock sold by her as income for that year. This was required by Section 202 (a) of the Revenue Act of 1921. She paid a tax upon the basis of the original return and thereafter protested against the tax upon the full amount of the proceeds * * *."

The $11,708.80 referred to is the gain that accrued prior to the time of acquisition by the taxpayer. It was against the tax on this amount only that she protested. (R. 7) The gain of $22,836.50 which accrued between the time she acquired it and the time of sale she reported and paid the tax based thereon without protest, assuming, of course, that the question as to the tax on this gain had long since been settled by the case of *Walsh* v. *Brewster, supra,* and companion cases.

3. The Circuit Court of Appeals erred in holding that Sec. 202 (a) (2), Revenue Act of 1921, was a legitimate and necessary exercise of a power ancillary to the power to levy taxes.

The Court below was swayed by the fact that Congress was seeking to supply an omission in previous income-tax laws. Judge Manton, in his opinion, said:

> "The obvious purpose of Section 202 (a) (2) was to prevent the loss of income represented within the profit to the donor during the period he held the property before he made the gift."
>
> * * * * * * *
>
> "The method of the statute which regards the corpus of the gift, irrespective of its value, as a thing which is transferred is essential to the entire taxing scheme."
>
> * * * * * * *
>
> "The statute may, indeed, be said to be an execution of the main design of the income-tax Act."

Judge Hand, in his concurring opinion, stated:

> "That the statute is reasonably ancillary to a valid constitutional provision seems to me as plain as in Rice v. Eisner, 16 Fed. (2) 353; that the practice, if permissible, will become a common contrivance to frustrate that purpose I have no doubt whatever."

But the reasoning of neither Judge Manton nor Judge Hand answers the question as to whether or not the amount received by the donee was "income." This Court clearly decided in *Eisner* v. *Macomber, supra,* that the Sixteenth Amendment gives power to tax "income" only and that Congress can not, by statutory edict, con-

vert something into income which is not, in fact and substance, income, and tax it as such, without violating the Constitution. In that case the question of the taxation of stock dividends was involved. At the time the decision was made the Government was in dire need of revenue, and yet this Court did not allow its opinion to be influenced by that fact when it was convinced that stock dividends were not income.

Furthermore, both of the Judges below writing opinions for reversal sought to support their conclusions by pointing out that the gap might have been closed by an excise tax. Judge Manton stated:

> "No one would have doubted the power of Congress to impose a tax upon the donor at the time of the gift and the tax could have been measured by the difference between the price paid for it and its value when he transferred it. Nor could it be criticised if the donee was left to pay the balance of the tax based upon the difference between the value on the date of acquisition and the value on the date of sale."

Judge Hand stated:

> "Therefore there is a subject-matter which Congress may tax without apportionment and part of which, after Eisner v. Macomber, it could not tax in any other way, except, perhaps, as an excise."

An excise tax on a gift has been upheld. *Anderson* v. *McNeir,* 16 Fed. (2) 970. But this fact is not a valid reason for upholding an income tax on something which is not income. The majority members of the Court failed to recognize the distinction between the principle of an income-tax law and an excise-tax law which was so

clearly pointed out by Judge Swan in his dissenting opinion.

Speaking of the gain upon a sale of the donee's property, Judge Hand says:

> "I am not concerned for the moment with whose gain it is, but that the whole gain is income can not, I submit, be disputed. If it is important I suggest that the language of the Amendment itself gives Congress power to lay taxes on incomes, not on persons."

But Congress has not, in any income-tax law, taken that view of the Amendment. This is sufficiently illustrated by the fact that the law in question levies the tax on the "income of every individual" (Sec. 210) and the Act throughout refers to persons, "persons" being defined as including "partnerships and corporations as well as individuals." (Sec. 1.)

4. The Circuit Court of Appeals erred in finding that the provisions of the Act were not capricious and arbitrary.

That the taxing power of Congress is not absolute and may be an invasion of the rights of citizens under the Fifth Amendment has been established. *Walter E. Frew, et al.*, v. *Bowers*, 12 Fed. (2) 625, and more recently by this Court in *Coolidge* v. *Nichols*, May 31, 1927. Judge Manton, in pointing out that the Act was not discriminatory, stated:

> "The method results in no greater tax than that which would have been imposed upon the donor and donee if each had been asked to pay a proportion of the tax based upon the amount of the increment when in the hands of each."

This is clearly an erroneous statement, if the donor's income was small and the donee's large, or *vice versa*, as is generally the case. The donor does not take the same tax liability that the donor would have had, had he sold the property, and that is one of the reasons why the tax is arbitrary and capricious. That the donee took it, knowing that some day he might be called upon to pay the tax, does not affect the fundamental consideration that the sum when realized is not "income" to him or that the application of the statute works arbitrary and capricious results. *Miles* v. *Graham*, 260 U. S. 501. In that case it was held that where a Federal Judge took his office subsequent to the passage of the Revenue Act (and, of course, charged with knowledge of its provisions) which attempted to declare his salary to be taxable, he was not deprived of the benefit of Article 3, Section 1, of the Federal Constitution, which provides that his salary shall not be diminished. Similarly, a person who receives property by gift, even though he knows that there is a Federal Statute which attempts to impress upon him an income tax, is not thereby deprived of his fundamental rights under Article 1 of the Constitution and the Sixteenth and Fifth Amendments thereof.

Conclusion.

Wherefore the petitioner respectfully prays that this Court take jurisdiction of this question because:

1. This case involves a vital and fundamental principle of income-tax law and is of great public interest.

2. The Court below erred in finding that increment in value which occurred prior to the ownership by the donee was income taxable to the donee.

3. The Court below erred in holding that Section 202 (a) (2) of the Revenue Act of 1921 was a legitimate and necessary exercise of a power ancillary to the power to levy taxes on incomes.

4. The Court below erred in finding that the application of the Statute, as applied to the donee, is not an arbitrary and capricious exercise of the power of taxation.

HENRY W. TAFT,
Counsel for the Petitioner,
40 Wall Street,
New York, N. Y.

Opinion of Judge Knox.

UNITED STATES DISTRICT COURT,

SOUTHERN DISTRICT OF NEW YORK.

ELIZABETH C. TAFT, *Plaintiff*, v. FRANK K. BOWERS, Collector of Internal Revenue for the Second District of the State of New York, *Defendant.*	L 35/86
GILBERT C. GREENWAY, JR., *Plaintiff*, v. FRANK K. BOWERS, Collector of Internal Revenue for the Second District of the State of New York, *Defendant.*	L 38/3

CADWALADER, WICKERSHAM & TAFT, Esqs., Attorneys for Plaintiff (HENRY W. TAFT and CLARENCE CASTIMORE, Esqs., of counsel);

BALDWIN, HUTCHINS & TODD, Esqs., Attorneys for Plaintiff (ROBERT A. YOUNG and E. RAYMOND SHEPARD, Esqs., of counsel);

HON. EMORY R. BUCKNER, United States Attorney, Attorney for Defendant (SHERWOOD E. HALL, Esq., Assistant United States Attorney, of counsel).

KNOX, *D. J.*:

It is my opinion that no part or portion of the value of an outright bona fide gift as of the date of delivery is, or can, constitute taxable income in the hands of the donee. So far as the latter is concerned, the gift is a capital transaction. His liability for future income therefrom must be based on the value of the gift as of the time the transaction is complete, and not upon the cost of the property at the date of its acquisition by the donor. If the construction of the tax law, for which the Government contends, should be applied, it means that the donee of property is to be taxed upon an increment in value which, if it can be regarded as income at all, is income to another, viz.: the donor. A tax levied upon that increment in the hands of the donee necessarily results in a direct levy upon the gift. If the gift consisted of money, would it be argued that the donee is to be taxed on the difference in value of the money, that is, its purchasing power, as between the date of its acquisition by the donor, and the date of its delivery to the donee? I think not. The money would be regarded as capital in the hands of the donee; and so, I think that that which may be converted into money, as of the date upon which it is given away, must, so far as the donee is concerned, also be regarded as capital.

According to my views, the 16th Amendment to the Constitution conferred no power upon the Congress to tax gifts.

Very likely, it is possible to devise reasonably plausible arguments to the effect that what is transferred by the donor is nothing more than his original investment

therein, and to cite various decisions which contain expressions that may be tortured to support the argument; but the fact remains that the common understanding of a gift is that the donee acquires, absolutely and completely, the entire value of the donation as of the date of transfer. Until a higher court than this is willing to endorse a different principle, I certainly shall not do so.

The motion to dismiss the complaint is denied and the plaintiffs may have judgment for the claim asserted against the Collector. He, of course, will be granted a certificate.

August 5, 1926.

U. S. D. J.

Opinion of Judge Manton.

UNITED STATES CIRCUIT COURT OF APPEALS

FOR THE SECOND CIRCUIT.

FRANK K. BOWERS, Collector of Internal Revenue for the Second District of the State of New York,
Plaintiff-in-Error (Defendant below),

against

ELIZABETH C. TAFT,
Defendant-in-Error (Plaintiff below).

FRANK K. BOWERS, Collector of Internal Revenue for the Second District of the State of New York,
Plaintiff-in-Error (Defendant below),

against

GILBERT C. GREENWAY, JR.,
Defendant-in-Error (Plaintiff below).

Before: MANTON, L. HAND and SWAN, *Circuit Judges.*

Writ of error to the District Court for the Southern District of New York. Actions by Elizabeth C. Taft and Gilbert C. Greenway, Jr., against Frank K. Bowers, Collector of Internal Revenue, defendant, to recover for

income taxes paid under protest. Judgments for plaintiffs; defendant appeals. Reversed.

CADWALADER, WICKERSHAM & TAFT, Esqs.,
Attorneys for Elizabeth C. Taft.
HENRY W. TAFT, Esq.,
CLARENCE CASTIMORE, Esq.,
of Counsel.

BALDWIN, HUTCHINS & TODD, Esqs.,
Attorneys for G. C. Greenway, Jr.
ROBERT A. YOUNG, Esq.,
E. RAYMOND SHEPARD, Esq.,
of Counsel.

CHARLES H. TUTTLE, Esq.,
United States Attorney.
SAMUEL C. COLEMAN, Esq.,
Asst. U. S. Attorney, of Counsel.

MANTON, *Circuit Judge:*

These cases were argued together and will be considered in one opinion. The defendant-in-error, Miss Taft, received a gift from her father of 150 shares of the common stock of the Nash Motors Company; 100 shares in December, 1921, and 50 shares in March, 1922. They were transferred on the books of the corporation in her name on December 26, 1922, when she became the record owner thereof. They were obtained by her father as a bonus in connection with the purchase of preferred stock of the Nash Motors Co. In February, 1923, the Nash Motors Co. declared a stock dividend of four shares of common and three shares of preferred on each share of common stock to the stockholders of record on December 26, 1922. As a result, she became the owner of 750 shares of common and 450 shares of preferred stock. After the receipt of this stock in 1923, she sold 200 shares

of common and 130 shares of preferred stock for $34,345.30. The market value of her 150 shares of common at the time she received the gift from her father was $42,350. The stock which she sold in 1923 brought $11,708 more than it was worth when she received it. In making her income tax return and paying the same for 1923, she included the entire gain of the sale of the stock sold by her as income for that year. This was required by §202 (a) of the Revenue Act of 1921. She paid a tax upon the basis of the original return and thereafter protested against the tax upon the full amount of the proceeds, arguing that she should have been required to account, as income, for the difference between the value of the stock when she acquired it and the price at which she had sold it, to wit, $11,708.80.

In Mr. Greenway's case, the action is to recover a tax paid under protest as income tax for the year 1922, payment being made in 1923. The stock sold by this defendant-in-error was also a gift made by his brother to him. The stock was likewise sold at a profit.

The statute involved, §202 (a) (2) of the Revenue Act of 1921, provides:

> "(a) That the basis for ascertaining the gain derived or loss sustained from a sale or other disposition of property, real, personal, or mixed, acquired after February 28, 1913, shall be the cost of such property; except that—"
>
> * * * * * * * *
>
> "(2) In the case of such property, acquired by gift after December 31, 1920, the basis shall be the same as that which it would have in the hands of the donor or the last preceding owner by whom it was not acquired by gift. If the facts necessary to determine such basis are unknown to the donee,

the Commissioner shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Commissioner finds it impossible to obtain such facts, the basis shall be the value of such property as found by the Commissioner as of the date or approximate date at which, according to the best information the Commissioner is able to obtain, such property was acquired by such donor or last preceding owner."

A profit resulting from the conversion of capital assets is income within the Sixteenth Amendment of the Constitution. *Merchants Loan & Trust Co.* v. *Smietanka*, 255 U. S. 509; *Eldorado Coal & Mining Co.* v. *Mager*, 255 U. S. 522; *Walsh* v. *Brewster*, 255 U. S. 536. Income from gifts is treated in the same manner as income from other sources, and income has been defined as gain derived from capital and labor or from both combined provided it be understood to include profit or gain through a sale or conversion of capital assets. *Eisner* v. *Macomber*, 252 U. S. 189. The statute here attacked recognized this definition of income and measures the profit or loss upon the sale or conversion of the gift as a difference between the price which the donor paid for it and the price which the donee obtained. The value of the property at the time the donor transferred it to the donee is ignored and Congress, in effect, charged the gift with the tax which the donor would have paid had he received the market value for it at the time of the gift.

The arguments of the defendants-in-error are that a gift is in the nature of capital assets and that no tax is imposed upon the gift as such. The arguments further are that by taxing as income the difference between the cost to the donor and the price realized by the donee,

the tax is being imposed upon the corpus of the gifts themselves and that §213 (b) of the statute forbids this. But the question is whether the method adopted by Congress for measuring income is, in the case of the donee, a reasonable one in the aid of the purposes of Federal income taxation. Section 213 (b) does not define what is income from a gift. The defendants-in-error accede to the position that what each received when they sold the property, if it shows an increase, is a profit but in measuring it, the price at the date each received the gift must be assumed to be its worth to them. But Congress has measured otherwise and it says, in protecting the government against loss of revenue, it is proper that where the donee pays nothing, it accepts as a measure of gain or loss the cost to the donor without reference to its actual value when received by the donee.

The obvious purpose of §202 (a) (2) was to prevent the loss of income represented within the profit to the donor during the period he held the property before he made his gift. Congress has determined that this same increment shall be recognized as income, even though a gift intervenes. The transfer by gift is but a change of ownership in the specific property. In doing this, Congress imposes no tax upon an unrealized gain. The value of the property is ignored or not taken into account until the property is finally disposed of in such a way that it could be determined that the owner made either a gain or a loss and, until there is a sale, there is no necessity for measuring income nor is there an opportunity to do so. This avoids tax evasion or tax avoidance. This statute puts the donee, who pays nothing for the property and who, therefore, loses nothing on any theory of eco-

nomic principle, in the position the donor would have been, in so far as taxation is concerned.

Nor does this method of taxation suggest that the statute is unconstitutional as in violation of the Fifth Amendment. While the power to tax is not absolute, a tax should be shown to be arbitrary and capricious before it is condemned. The power of Congress to tax as permitted under the Sixteenth Amendment must be recognized as well as protection under the Fifth Amendment. The method of the statute which regards the corpus of the gift, irrespective of its value, as a thing which is transferred is essential to the entire taxing scheme. The method results in no greater tax than that which would have been imposed upon the donor and the donee, if each had been asked to pay a proportion of the tax based upon the amount of the increment when in the hands of each. Only the income from the gift is affected by the statute. It is not the donee's income from other sources. The statute is prospective in operation and relates to gifts made after a certain date. A donee must, therefore, be charged with the knowledge that under the law, the gift may be worth less to him because of the necessity of sharing part of the profits with the government —that part which had accumulated up to the time he had received the gift. The argument against the constitutionality of the section loses sight of the fact that the statute is directed toward a means for collecting the revenue which is made available under the income tax statute. *Knowleton* v. *Moore,* 178 U. S. 41; *N. Y. Trust Co.* v. *Eisner,* 256 U. S. 345.

The statute may, indeed, be said to be an execution of the main design of the income tax act. That it is proper to ignore the value of property at the time of the

gift is illustrated by the Excess Profits Tax. A tax upon a donor for making a gift is not in violation of the Constitution. *Anderson* v. *McNeir*, 16 F. (2d) 970.

The Supreme Court said in *LaBelle Iron Works* v. *United States*, 256 U. S. 377:

> "Nor can we regard the act—in basing 'invested capital' upon actual costs to the exclusion of higher estimated values—as productive of arbitrary discriminations raising a doubt about its constitutionality under the due process clause of the Fifth Amendment. The difficulty of adjusting any system of taxation so as to render it precisely equal in its bearing is proverbial, and such nicety is not even required of the States under the equal protection clause, much less of Congress under the more general requirement of due process of law in taxation. Of course it will be understood that Congress has very ample authority to adjust its income taxes according to its discretion within the bounds of geographical uniformity. Courts have no authority to pass upon the propriety of its measures; and we deal with the present criticism only for the purpose of refuting the contention, strongly urged, that the tax is so wholly arbitrary as to amount to confiscation."

So here Congress, in effect, has said that notwithstanding the value of the property, from an economic standpoint for the purpose of this taxation, that value is ignored and only the value when the property was acquired by the donor is considered. This is deemed necessary to the enforcement of this aspect of the Income Tax Law where a gift is made and where a profit or loss is afterwards realized and it becomes necessary to make proper measurement thereof. Although popularly the

gift has a fixed value at the date of transfer, there is no Constitutional objection, for income tax purposes, in rejecting or in ignoring that fact and holding that the rights transferred by the gift which include the increment while in the hands of the donor, are subject to the tax. No one would have doubted the power of Congress to impose a tax upon the donor at the time of the gift and the tax could have been measured by the difference between the price he paid for it and its value when he transferred it. Nor could it be criticized if the donee was left to pay the balance of the tax based upon the difference between the value on the date of acquisition and the value on the date of sale. The statute does no more than tax the donee for a gift when he sells it and measures that income for income tax purposes as based upon the difference between the cost when acquired by the donor and the price realized by the donee. It is not capricious to put property acquired by gift in a special class and to tax it differently from property acquired by purchase. *Bowman* v. *Cont. Oil Co.*, 256 U. S. 642; *Brushaber* v. *Union Pac. R.R. Co.*, 240 U. S. 1; *Thomas* v. *U. S.*, 192 U. S. 363. It is sufficient for the main purposes of the Sixteenth Amendment and the Income Tax enactments pursuant thereto, if the method of taxation is consistent with the entire scheme of taxation and the tax imposed by that method may not be considered direct.

We think that Congress in levying the tax here was well within its constitutional power in creating a classification which was reasonable and neither the tax nor the method of enforcing it was arbitrary or capricious. *Barclay & Co.* v. *Edwards*, 267 U. S. 442.

The judgments below are reversed with costs.

Judge Swan dissents.

Opinion of Judge Hand.

UNITED STATES CIRCUIT COURT OF APPEALS

FOR THE SECOND CIRCUIT.

FRANK K. BOWERS, Etc.,
Plaintiff-in-Error,

against

ELIZABETH C. TAFT,
Defendant-in-Error.

FRANK K. BOWERS, Etc.,
Plaintiff-in-Error,

against

GILBERT C. GREENWAY, JR.,
Defendant-in-Error.

L. HAND, Circuit Judge (concurring): In each of these cases the amount of the tax does not exceed the increase in value of the gift while in the donee's hands. Strictly speaking, the question does not therefore arise whether Congress may, as a tax on income, seize any part of the increase in value of the gift before the donee accepted it. I am not entirely sure that a tax, if limited to the increase in the donee's hands, might not be calculated upon the difference between what the donor paid and the donee got. At the argument, I was disposed to think that these cases might be decided on some such reasoning, but it is pretty clear that that would make a new statute. Congress did not mean so to limit the tax. In the first place the results would be so capricious that the validity

of the law might be doubtful, and in the second, much revenue would be lost which was certainly intended to be reached. We may hardly so far strain the law to save it. So I think that this act must be good in whole or not at all.

No increase in value not realized in cash can be taxed as income under the Sixteenth Amendment; that was very deliberately decided in *Eisner* v. *Macomber*, 252 U. S. 189. If so, it is impossible to tax the increase in the donor's hands at all; it is not income, though at any time by a sale he could have made it such. The same increase is as little income, even after it has passed to the donee, until he sells. However, it seems to me equally clear that when he does, there has been a gain which is in every sense income, to the extent of the difference between what the donor paid and the donee got. I am not concerned for the moment with whose gain it is, but that the whole gain is income cannot, I submit, be disputed. If it is important, I suggest that the language of the Amendment itself gives Congress power to lay "taxes on incomes," not on persons. Therefore, there is a subject-matter which Congress may tax without apportionment, and part of which, after *Eisner* v. *Macomber*, it could not tax in any other way, except perhaps as an excise.

I can see no injustice in regarding the whole of this gain as income of the donee, and if there be no injustice certainly it is not within the Fifth Amendment. Suppose that the law charged the corpus of the gift while in the donor's hands with an inchoate tax at specified rates, to be calculated upon its increase whenever it was sold. The donee in accepting such a gift would take it subject to that charge, though its amount would remain unde-

termined until he sold. I can see nothing unconstitutional in that, nor in imposing upon him a corresponding duty in personam because of his acceptance. So far as that would involve uncertainty, arising from fluctuation in value of the gift after acceptance, it would be entirely within the donee's control, for he may sell when he likes, and could scarcely complain of any increase which might result from his delay. It is true that Congress has gone further than that, because it has made the whole gain a part of his income for the year in which he sells. But again so far as that is dependent upon the amount of his other income, he can reckon with it when he accepts the gift, and of any subsequent fluctuation he takes his chance, precisely as he does of fluctuation in the value of the gift.

Therefore, I fail to see any oppression in this method of calculating the tax upon what, as I have said, appears to me an unquestionable subject-matter for taxation. In *Lynch* v. *Turrish,* 247 U. S. 221, the gain had accrued before the Amendment went into effect. I read *Gray* v. *Darlington,* 15 Wall. 63, in the same sense, though perhaps it was only a forerunner of *Eisner* v. *Macomber,* 252 U. S. 189. *People ex rel. Brewster* v. *Wendell,* 196 App. Div. 596, dealt with a statute which sought to tax the donor, and was void where *Eisner* v. *Macomber* is law. That the statute is reasonably ancillary to a valid constitutional purpose seems to me as plain as in *Rice* v. *Eisner,* 16 Fed. (2) 358 (C. C. A. 2); that the practise, if permissible, will become a common contrivance to frustrate that purpose, I have no doubt whatever.

I concur with my brother Manton.

Dissenting Opinion of Judge Swan.

UNITED STATES CIRCUIT COURT OF APPEALS

FOR THE SECOND CIRCUIT.

FRANK K. BOWERS, Etc.,
Plaintiff-in-Error,

v.

ELIZABETH C. TAFT,
Defendant-in-Error.

FRANK K. BOWERS, Etc.,
Plaintiff-in-Error,

v.

GILBERT C. GREENWAY, JR.,
Defendant-in-Error.

SWAN, Circuit Judge (dissenting): I am unable to agree with the result reached by my colleagues. Section 202 (a) (2) of the Revenue Act of 1921 attempts to include as income of the donee, sustained upon sale of the gift, the increment in value which accrued during the time the property was owned by the donor, or by his predecessor in title if the donor himself received it as a gift. It has been established that Congress may not tax as income what in fact is not income, without apportioning the tax according to the constitutional requirement. *Eisner* v. *Macomber*, 252 U. S. 189. Property obtained by gift is capital, not income in the hands of the donee upon its receipt. *Edwards* v. *Cuba Railroad*, 268 U. S. 628; *United States* v. *Oregon-Washington &c Co.*, 251 F. 211 (C. C. A. 2). This is expressly recognized by the declaration of Section 213 (b) (3) of the Revenue Act of 1921 to the effect that gross income shall not include the value

of property acquired by gift but only the income from such property. But Section 202 defines the income from such property as including the increment in value which accrued before the donee became owner of the property. This is an attempt to declare to be income of the donee, when realized by sale of the gift, something which was part of the donee's capital before the sale.

In *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179, Mr. Justice Pitney, speaking for a unanimous court, said:

> "In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration."

It was held that where the increase in capital value occurred before the passage of the taxing act, such increase is not taxable as income upon sale of the property. A similar decision as to the Income Tax Act of 1913 appears in *Lynch* v. *Turrish*, 247 U. S. 221. I am unable to see why these cases are not applicable. The period under consideration in determining the gain realized by the taxpayer donee is the period of the donee's ownership. Only by giving an unreal valuation to the capital of the donee, namely, the cost of the gift to the donor or his predecessor in title, is it possible to consider the total gain above such cost as income to the donee realized by his sale. It does not seem to me a sufficient answer to say that the donee accepts the gift with knowledge that Congress has declared it to have this fictitious valuation for income tax purposes. The tax is not an excise on the privilege of accepting the gift; it is an income tax, and the taxpayer's income must be a gain derived from *his* capital, or *his* labor, or from both combined.

It is my opinion, therefore, that the judgments should be affirmed.